

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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PLR-151867-09

Date:
April 29, 2010

Legend

X =

State =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

\$n =

Date 1 =

Date 2 =

Dear :

This letter responds to your letter dated , and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

X was incorporated under the laws of State in Year 1. X elected to be an S corporation effective Date 1. At the time X made its S election, X's accountants believed that X did not have accumulated earnings and profits. For each of the consecutive years of Year 2, Year 3, and Year 4, X had passive investment income in excess of 25 percent of its yearly gross receipts. During Year 5, X engaged a new accountant who determined that X had accumulated earnings and profits of \$n. X will elect pursuant to § 1.1368-1(f)(3) of the Income Tax Regulations to distribute all of its accumulated earnings and profits, \$n, to its shareholders through a deemed dividend in Year 5.

X represents that X and its shareholders did not intend to terminate X's S corporation election and were not aware of the termination until Year 5. X and its shareholders have treated X as an S corporation since Date 1. X represents that the termination was not motivated by tax avoidance or retroactive tax planning. X and X's shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

Law and Analysis

Section 1361(a)(1) provides that the term "S corporation" means a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that any termination under § 1362(d)(3) becomes effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i).

Section 1362(d)(3)(C)(i) provides that, except as otherwise provided in § 1362(d)(3)(C), "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments

(consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1368(c) provides rules for determining the source of distributions made by an S corporation having accumulated earnings and profits with respect to its stock. Section 1368(e)(3) and § 1.1368-1(f)(2) provide that an S corporation may, with the consent of all its affected shareholders, elect to distribute earnings and profits first.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its accumulated earnings and profits through a deemed dividend. If an S corporation makes the election provided in § 1.1368-1(f)(3), the S corporation will be considered to have made the election under § 1368(e)(3) and § 1.1368-1(f)(2) to distribute earnings and profits first.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25 percent of which are passive investment income (within the meaning of § 1362(d)(3)).

Conclusion

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 2 under § 1362(d)(3)(A) because X had accumulated earnings and profits at the close of each of three consecutive taxable years beginning in Year 2, and gross receipts for each of those taxable years more than 25 percent of which were passive investment income.

We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation beginning on Date 2 and thereafter, provided that X's S corporation election was valid and has not otherwise terminated under § 1362(d).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding whether X's S election is otherwise valid.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

/s/

David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)